

Farm Credit Administration



Semiannual Report to Congress on

# Farmer Mac

Federal Agricultural Mortgage Corporation

as of June 30, 2004

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on  
Farmer Mac  
(Federal Agricultural Mortgage Corporation)**

as of  
June 30, 2004

by the  
Office of Secondary Market Oversight  
Farm Credit Administration

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## Preface

This report to Congress summarizes the Federal Agricultural Mortgage Corporation's (Farmer Mac or Corporation) business performance for the first half of 2004 and financial condition as of June 30, 2004.

The Senate Committee on Agriculture, Nutrition, and Forestry and the House Committee on Agriculture requested that the Farm Credit Administration (FCA or Agency), in cooperation with the Department of the Treasury, to report semiannually on the financial condition of Farmer Mac.<sup>1</sup> The committees requested FCA provide this report "during the capital deferral period and beyond, if necessary." The capital deferral period is the 3-year delayed implementation of the Risk-Based Capital regulations for Farmer Mac as required by the Farm Credit System Reform Act of 1996 (1996 Act). Even though the deferral period has passed and the regulations are implemented, the FCA deems it useful to continue preparing this report to provide a concise summary of Farmer Mac's financial condition and other activities.

## Corporate Profile

Farmer Mac is a federally chartered instrumentality of the United States created in 1988 to establish a secondary market arrangement for agricultural real estate and rural housing mortgage loans.

The 1996 Act made significant changes to Farmer Mac's charter that allowed it to grow rapidly through new business strategies and total program activity is now roughly \$5.6 billion. Non-program investments were \$1.6 billion, resulting in Farmer Mac managing or guaranteeing assets of nearly \$7.3 billion at June 30, 2004. Changing business strategies and growth of program assets from 1999 to 2002 caused an evolution in the Corporation's risk profile. That evolution is marked by an increase in the size and complexity of financial and operational risks to be managed.

The Corporation conducts its business through two programs, Farmer Mac I and Farmer Mac II. In the Farmer Mac I program, Farmer Mac purchases or commits to purchase qualified loans or securities backed by qualified loans. Under the Farmer Mac II program, Farmer Mac purchases the guaranteed portions of loans backed by the United States Department of Agriculture.

Farmer Mac is a publicly traded corporation, whose stock is traded on the New York Stock Exchange under the symbols "AGMa" for Class A and "AGM" for Class C shares (detailed below). Farmer Mac has three classes of common stock:

1. Class A Voting Common Stock may only be held by banks, insurance companies, and other financial institutions that are not institutions of the Farm Credit System. No owner of Class A stock may hold more than 33 percent of the outstanding shares of Class A stock.
2. Class B Voting Common Stock may only be held by institutions of the Farm Credit System and are not exchange-traded. There are no restrictions on the maximum purchase or holdings of Class B stock.

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<sup>1</sup> The request was by letter to FCA dated December 22, 1995, from the Chairmen of the Senate Committee on Agriculture, Nutrition, and Forestry and the House Committee on Agriculture.

3. Class C Non-Voting Common Stock has no ownership restrictions.

The Farmer Mac Board of Directors (Board) is comprised of 15 members. Five are elected by Class A common stock shareholders. Five are elected by holders of Class B common stock. The President of the United States appoints the remaining five, and one of these is appointed by the President as chairperson.

Farmer Mac is regulated by the FCA through the Office of Secondary Market Oversight (OSMO). OSMO was established in 1992 by Public Law 102-237 to provide for the examination and general supervision of Farmer Mac's safe and sound performance of its powers, functions, and duties. Farmer Mac is subject to disclosure and reporting requirements of the Securities and Exchange Commission (SEC).

## Highlights

Farmer Mac's program activity and financial condition as of June 30, 2004, and the first half of 2004 are reflected by the following:

### Program Activity

- On- and off-balance sheet program-related activity declined to \$5.6 billion from \$5.8 billion at yearend 2003, representing a reduction of 2.5 percent.
- Long-Term Standby Purchase Commitment (Standby or LTSPC) volume outstanding totaled \$2.4 billion, up 1.8 percent during the first half of 2004. Standby volume represents 42.4 percent of all program activity and dominates the Corporation's off-balance sheet guarantee business.
- Post-1996 Act Farmer Mac I loan volume purchased or guaranteed that was 90 days or more past due, in foreclosure, in bankruptcy, or Real Estate Owned (REO) was 1.4 percent of all post-1996 Act Farmer Mac I loan volume outstanding. This compares to 1.6 percent at June 30, 2003. REO was down \$6.3 million from yearend 2003.
- The reported allowance for losses decreased 1.2 percent to \$21.8 million at June 30, 2004, compared to \$22.1 million at December 31, 2003. Charge-offs on loans net of recoveries during the first half of 2004 were \$3.5 million, compared to \$2.3 million over the same period in 2003.

### Financial Condition

- Net worth increased 6 percent to \$226.1 million from \$213.3 million at yearend 2003. However, Farmer Mac's recently announced stock repurchase and dividend payment programs will factor into the overall future growth of net worth from retained earnings.<sup>2</sup>
- Farmer Mac's statutory minimum core capital<sup>3</sup> requirement was \$136.4 million. Core capital available to meet this requirement was \$226.3 million.

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<sup>2</sup> In August, Farmer Mac announced a 10 cent per share quarterly dividend on all classes of common stock beginning the fourth quarter 2004. They also announced a repurchase program for up to 10 percent of Class C common stock.

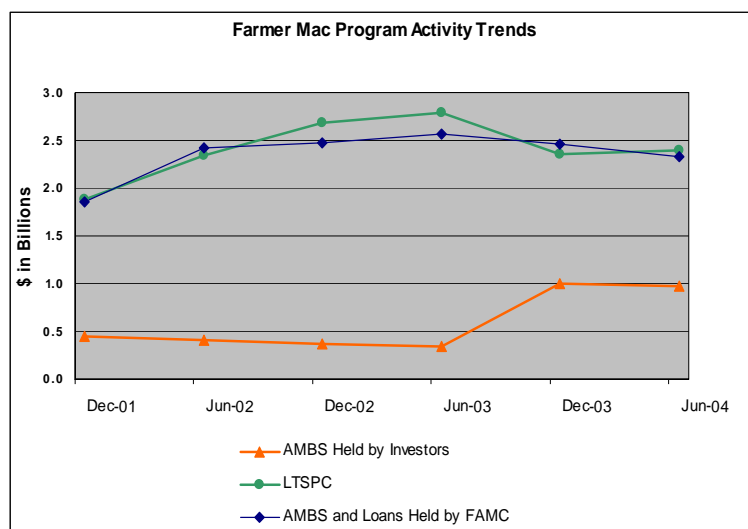
- Farmer Mac's risk-based regulatory capital requirement was \$49.3 million. Regulatory capital available to meet this requirement was \$247.5 million. Additional information on capital levels is found in the Net Worth analysis section and in Table 3.
- Farmer Mac remains in Enforcement Level I with core capital and regulatory capital exceeding statutory minimum and regulatory risk-based capital requirements, respectively.
- Non-program investments remained relatively stable at 29.1 percent of Farmer Mac I program assets including Standbys ("Standbys" are described on page 4) and totaled \$1.6 billion at June 30, 2004.
- Net income available to common stockholders for the 6-month period ended June 30, 2004, was \$9.8 million, a 41.7-percent decrease over the same 6-month period in 2003.

## Overview of Program Activity and Financial Performance

### Program Activity

Farmer Mac's on- and off-balance sheet program activity declined slightly to \$5.6 billion at June 30, 2004, a decrease of \$143.7 million, or 2.5 percent, from December 31, 2003. On-balance sheet activities decreased 6.2 percent, while off-balance sheet program activities increased by 0.2 percent.

On-balance sheet program assets include agricultural mortgage-backed securities (AMBS),<sup>4</sup> loans, REO, and AgVantage bonds. During the first half of 2004, the principal amount of on-balance sheet program assets was down \$150.2 million, or 6.2 percent, excluding REO. The impact of this decline in on-balance sheet activity was offset by a slight increase in off-balance sheet Standby commitments of \$42.1 million. However, total off-balance sheet program activity outstanding was up a slight \$6.5 million.



<sup>3</sup> Core capital is defined as the sum of the following, as determined in accordance with Generally Accepted Accounting Principles (GAAP): (1) the par value of outstanding common stock, (2) the par value of outstanding preferred stock, (3) paid-in capital, and (4) retained earnings.

<sup>4</sup> AMBS are of two types based on different kinds of agricultural mortgages. Farmer Mac I is comprised of mortgages secured by the first liens on agricultural real estate or rural housing loans purchased from lenders and represents the primary source of Farmer Mac business activity. Farmer Mac II consists of the portion of certain types of loans guaranteed by the U.S. Department of Agriculture.

Farmer Mac continues to hold more loans and AMBS in portfolio than it sells to investors. This is the result of Farmer Mac adopting a retained portfolio strategy in the third quarter of 1998 due to economic considerations. That is, Farmer Mac generally retains rather than sells AMBS when the estimated present value of the net interest income to be generated over the life of the AMBS is greater than the potential one-time gain on the sale of AMBS.

Total off-balance sheet program activity was \$3.36 billion at June 30, 2004, up slightly from \$3.35 billion at yearend 2003. This increase in Standby program activity partially offset the decline in AMBS held by investors, which was down \$35.6 million. Under the Standby program, a financial institution acquires a Farmer Mac guarantee on a defined pool of loans for an annual fee paid to Farmer Mac. The institution retains the loans in-portfolio. Farmer Mac's guarantee is to purchase loans from the pool under certain specified conditions at the request of the institution. While the Standby program is available to agricultural lenders generally, Farm Credit System institutions account for all Standby program volume to date.

The Standby program has grown significantly since its inception in 1999, but volume has been flat for roughly 18 months (excluding a single transfer of \$722.3 million from Standbys to AMBS in mid-2003). Farmer Mac has attributed a portion of the dramatic drop-off in new Standby business, in part, to regulations and positions taken by FCA and the Farm Credit System Insurance Corporation with respect to the need for counterparty risk management in System institutions. Other contributing factors include ample liquidity among rural lenders and slower refinancing of loans due to the current environment of increasing interest rates.

### **Funding Activity**

The Farmer Mac Board policy authorizes the issuance of debt obligations, principally discount notes (DNs) and medium-term notes (MTNs), to fund Farmer Mac I and II programs, and to conduct other activities of the Corporation, such as maintaining investments in non-program assets for liquidity purposes. The liquidity portfolio is available to meet maturing debt obligations in the event of a short-term disruption in the capital markets that prevents Farmer Mac from issuing new debt. The liquidity portfolio consists of nonprogram investments, which are defined as investment securities, cash, and cash equivalents. Farmer Mac's liquidity policy requires it maintain a minimum of 60 days of maturing obligations with a target of 90 days.

Farmer Mac has policy limits on the maximum amount of MTNs and DNs that may be outstanding at any one time for the purpose of funding Farmer Mac I and II and the liquidity portfolio, and on the maximum amount of nonprogram investments that may be held in the liquidity portfolio. Farmer Mac's Board also has set limits on the aggregate amount of credit exposure to any one issuer of investment instruments.

FCA examines and monitors Farmer Mac's non-program investments on an ongoing basis to ensure that non-program investments primarily serve the Corporation's statutory mission and are not used solely for income generation. Further, FCA issued a proposed rule on Non-Program Investments and Liquidity in June 2004; see the Regulatory Activities section for further details.

### **Capital Position**

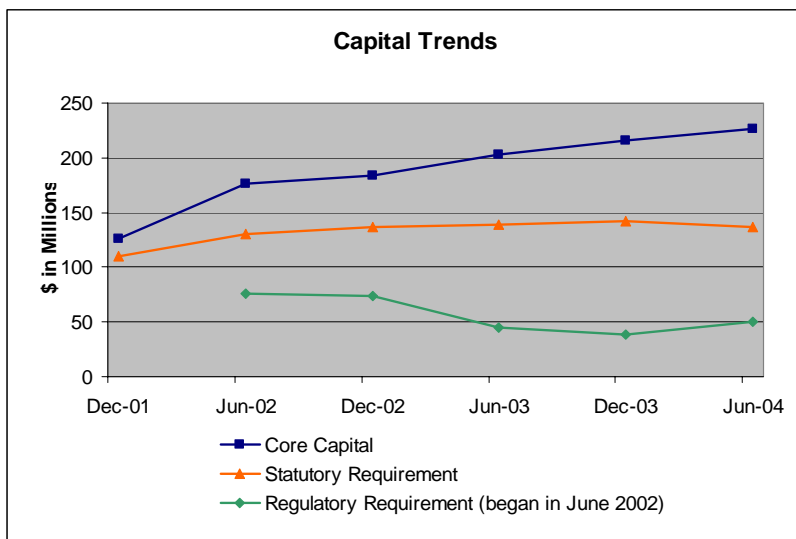
Farmer Mac's net worth, or capital reported in compliance with GAAP, at June 30, 2004, was \$226.1 million. Capital increased \$12.8 million, or 6.0 percent, from yearend 2003. The Corporation's core capital remained above the \$136.4 million statutory minimum prescribed

by Section 8.33 of the Farm Credit Act of 1971, as amended (Act).<sup>5</sup> In 1999, statutory minimum core capital requirements became fully phased in at 2.75 percent of on-balance sheet assets and 0.75 percent of off-balance sheet guarantees.

Farmer Mac's application of the risk-based capital stress test as of June 30, 2004, produced a regulatory capital requirement of \$49.3 million. Farmer Mac's regulatory capital to meet this requirement was \$247.5 million.

The dividend policy and stock repurchase programs announced August 9, 2004, will impact earnings and outstanding common shares. Given the current

number of shares outstanding, the estimated cost of the dividend policy is roughly \$5 million per year under current business conditions. As a result, the retention of earnings will be reduced and net worth will grow more slowly from this capital source. The impact of the stock repurchase program will depend on share prices at the time of repurchase. Repurchases made under this authority, if any, will occur more gradually over time in accordance with SEC requirements on buying back stock. Farmer Mac is expected to continue to meet existing statutory and regulatory capital requirements regardless of the dividend and stock repurchase programs.



Farmer Mac remains in Enforcement Level I as defined in Section 8.35 of the Act. That is, Farmer Mac's core capital equaled or exceeded the minimum core capital requirement set forth in Section 8.33 of the Act, and its regulatory capital equaled or exceeded the risk-based capital requirement. Enforcement Levels II – IV require that FCA place certain supervisory restrictions on Farmer Mac.

### Net Income Analysis

Farmer Mac's net income available to common stockholders for the first half of 2004 was \$9.8 million, a 41.7-percent decrease from the same period in 2003. The decrease in net income primarily resulted from:

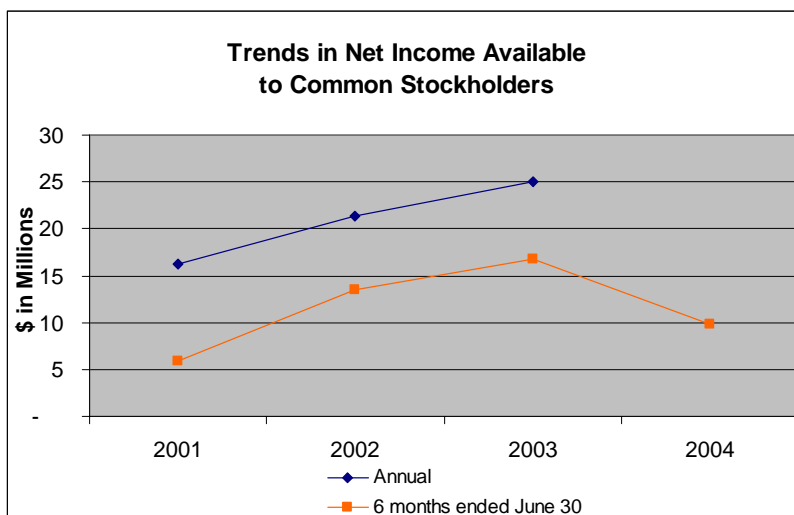
- An unrealized loss of \$2.9 million from fluctuations in the fair market value of trading assets and financial derivatives accounted for in accordance with SFAS 133.
- A 25.3 percent increase in the Corporation's operating expenses, driven by a 61.9 percent increase in general and administrative expenses, a 38.7 percent increase in regulatory fees, and a 20.9 percent increase in compensation expense.

<sup>5</sup> Ibid.



- A decline in net interest income associated with rate and volume changes on interest-bearing assets and interest-bearing liabilities that caused the average net yield to tighten 8 basis points to 0.87 percent at June 30, 2004 from 0.93 percent at yearend.

While GAAP income fluctuated due to fair market value accounting requirements, core earnings remained consistent. Core earnings for the first half of 2004 totaled \$12.1 million, compared to \$11.7 million, before adjustments for non-recurring and



infrequent income items such as payments received by Farmer Mac to satisfy breaches of representations and warranties associated with purchased loans.<sup>6</sup>

### Performance of Guaranteed Loans

Farmer Mac assumes 100 percent of the credit risk on post-1996 Act Farmer Mac I portfolio, which includes Standby obligations. Pre-1996 Act Farmer Mac I guaranteed loans are supported by subordinated interests representing at least 10 percent of the initial balance of the loans underlying the securities. Given the first loss position of the subordinated interest, Farmer Mac does not expect to incur any losses on the pre-1996 guarantees.

At June 30, 2004, nonperforming post-1996 Act guaranteed loans, loans held on balance sheet, and Standbys declined as a percent of assets. Nonperforming assets were 1.4 percent of the outstanding balance Farmer Mac I portfolio, down from 1.6 percent a year earlier. REO is also down \$6.3 million to \$9.2 million from \$15.5 million at yearend due to completed liquidation activities.

### Allowance for Losses and Charge-Offs Analysis

The Corporation's SEC-reported allowance for losses at June 30, 2004, decreased to \$21.8 million, from \$21.9 million at June 30, 2003. The provision for losses for the 6-month period ended June 30, 2004, was \$3.2 million, compared to \$4.1 million for the same period in 2003.

Farmer Mac's allowance for loan losses has remained at between 0.35 and 0.45 percent of total covered assets. Post-1996 program activity is used as a proxy for covered assets here because of the small relatively risk-free characteristics of pre-1996 program assets. The relationship between the Allowance and nonperforming assets has also been relatively stable since June 2001.

<sup>6</sup> Core earnings are a non-GAAP measure of financial results that excludes the effects of certain unrealized gains and losses and non-recurring items. Farmer Mac began reporting core earnings to present an alternative measure of earnings performance. The components included in core earnings calculations are at the reporting entity's discretion.

## **Regulatory Activities**

FCA regulates, examines, and supervises Farmer Mac through authorities granted by Title VIII of the Act. The Agency is authorized to promulgate regulations, examine all books and records of Farmer Mac, and ensure safe and sound operations of Farmer Mac through enforcement supervisory actions that are comparable with those of other financial regulators, such as the Comptroller of the Currency. For example, the statute provides the FCA Board with enforcement powers for cease and desist orders, civil money penalties, the suspension or removal of directors or officers, and both conservatorship and receivership authorities.

### **Examination**

By statute, FCA must examine Farmer Mac's operations once each year. The FCA does not make public institution-specific examination findings, recommendations, or supervisory follow-up activities. Ongoing monitoring and follow-up on examination findings and recommendations are conducted through the Agency's Office of Secondary Market Oversight and is independent and separate from other such activities affecting other institutions of the Farm Credit System.

The recent examination was conducted with an "as of" date of July 31, 2004. The examination is risk-based and focused on what is commonly referred to by Federal financial regulators as a "CAMELS" assessment. A CAMELS assessment includes analyses of the institution's Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to market risk.

### **Regulations**

The current FCA Unified Agenda and Regulatory Performance Plan include two regulatory projects and two policy studies related to Farmer Mac. FCA published proposed regulatory standards for Non-Program Investments and Liquidity requirements for Farmer Mac in June 2004. FCA is now reviewing the comments to that proposed rule, and a final rule is expected in early 2005. The second project involves technical adjustments and other enhancements to the Risk-Based Capital Stress Test (12 CFR 650) and is targeted for consideration by the FCA Board in March 2005.

### **Government Accountability Office (GAO)**

Two policy studies are underway that address two recommendations made by the GAO in its October 16, 2003, report entitled, Farmer Mac: Some Progress Made, but Greater Attention to Risk Management, Mission, and Corporate Governance Is Needed. The first study focuses on the credit rating requirements of other regulators. The second study, which is in the initial planning stages, considers Farmer Mac's impact on agricultural real estate lending markets.

## Historical Data

Table 1

### FARMER MAC CONDENSED BALANCE SHEET (\$000,000)

<u>Date</u>	<u>Assets</u>	<u>Liabilities</u>	<u>Net Worth</u>
12-31-98	1,936.0	1,855.1	80.9
06-30-99	2,565.5	2,481.2	84.3
12-31-99	2,590.4	2,503.3	87.1
06-30-00	2,703.3	2,609.8	93.5
12-31-00	3,160.9	3,028.2	132.7
06-30-01	3,209.1	3,098.4	110.7
12-31-01	3,417.2	3,282.8	134.4
06-30-02	4,037.6	3,852.6	185.0
12-31-02	4,222.6	4,039.0	183.6
06-30-03	4,267.8	4,065.2	202.7
12-31-03	4,299.7	4,086.4	213.3
06-30-04	4,080.6	3,854.5	226.1

**Table 2**  
**FARMER MAC CONDENSED STATEMENT OF OPERATIONS**  
(\$000,000)

<u>Date</u>	<u>Total Revenue</u>	<u>Total Expenses</u>	<u>Net Income Available to Common Stockholders</u>	<u>Core Earnings</u>
12-31-98	15.8	10.1	5.7	N/A
06-30-99*	10.8	7.5	3.3	N/A
12-31-99	22.6	15.7	6.9	N/A
06-30-00*	14.4	9.6	4.8	N/A
12-31-00	29.8	19.4	10.4	N/A
06-30-01*	18.5	12.6	5.9	N/A
12-31-01	42.0	25.7	16.3	N/A
06-30-02*	26.4	12.9	13.5	11.1
12-31-02	51.3	30.0	21.3	22.9
06-30-03*	34.0	17.2	16.8	11.7
12-31-03	54.8	29.8	25.0	23.0
06-30-04*	24.9	15.1	9.8	12.1

"Total Revenue" and "Net income Available to Common Stockholders" are Farmer Mac's reported amounts on the Condensed Consolidated Statements of Operations. "Total Expenses" is the difference between these amounts.

\* Asterisks indicate numbers for the first six month period of each operating year. For consistency, amounts should be compared to comparable periods.

**Table 3**

**FARMER MAC COMPLIANCE WITH CAPITAL REQUIREMENTS  
AND ENFORCEMENT LEVEL**

(\$000,000)

<u>Date</u>	<u>Core Capital</u>	<u>Required Core Capital</u>	<u>Excess Core Capital</u>	<u>Regulatory Capital</u>	<u>Required Regulatory Capital</u>	<u>Excess Regulatory Capital</u>	<u>Enforce- ment Level<sup>7</sup></u>
12-31-98	80.7	50.2	30.5	N/A	N/A	N/A	I
12-31-99	88.8	79.6	9.2	N/A	N/A	N/A	I
12-31-00	101.2	96.9	4.3	N/A	N/A	N/A	I
12-31-01	126.0	110.5	15.5	N/A	N/A	N/A	I
12-31-02	184.0	137.2	46.9	204.0	73.4	130.6	I
12-31-03	215.5	142.0	73.5	237.6	38.8	198.8	I
06-30-04	226.3	136.4	89.9	247.5	49.3	197.1	I

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<sup>7</sup> Section 8.35 of the Act provides for four levels of classification relative to Farmer Mac's capital adequacy, with Level I indicating that Farmer Mac meets both the risk-based and minimum capital requirements. Since Farmer Mac was not required to be in compliance with the risk-based capital regulation until May 23, 2002, the fact that Farmer Mac's core capital is above the statutory minimum core capital requirement warrants an Enforcement Level I classification prior to that date.

**Table 4**

**OUTSTANDING FARMER MAC LOANS AND GUARANTEES**

	June 30 (\$000,000)			Change 2003- 2004
	2002	2003	2004	Percent
<b>1. On-Balance Sheet</b>				
a. Farmer Mac I (Post-1996 Act)	\$990.2	\$ 815.4	\$ 629.2	-23%
b. Farmer Mac I (Pre-1996 Act)	37.7	28.1	22.2	-21%
c. Farmer Mac II	546.3	604.4	669.3	11%
d. Loans Held for Investment	765.3	873.4	841.5	-4%
e. Loans Held for Sale	24.3	48.9	23.9	-51%
f. Loans Purchased from AMBS Pools	31.4	48.8	66.0	35%
g. Real Estate Owned	3.3	12.9	9.7	-25%
h. AgVantage Bonds	<u>28.1</u>	<u>23.6</u>	<u>29.3</u>	<u>24%</u>
i. Subtotal	<u>2,426.6</u>	<u>2,455.5</u>	<u>2,291.1</u>	<u>-7%</u>
<b>2. Off-Balance Sheet</b>				
a. Farmer Mac I (Post-1996 Act)	338.4	282.9	921.3	226% *
b. Farmer Mac I (Pre-1996 Act)	0.15	--	--	N/A
c. Farmer Mac II	71.2	64.5	46.5	-28%
d. Long-Term Standby Purchase Commitments	<u>2,336.9</u>	<u>2,790.5</u>	<u>2,390.8</u>	<u>-14%*</u>
e. Subtotal	<u>2,746.7</u>	<u>3,137.9</u>	<u>3,358.6</u>	<u>7%</u>
<b>TOTAL (1.i. + 2.e.)</b>	<u>\$5,173.3</u>	<u>\$5,593.4</u>	<u>\$5,649.7</u>	<u>1%</u>

\* Significant portion of the change due to conversion of Standbys into AMBS in the third quarter of 2003.

Amounts could vary slightly from certain SEC 10-K reported amounts due to timing differences in FAMC reports to OSMO and the SEC.